COURSE LEARNING OUTCOMES

At the end of this course the students will be able to

CLO 2 Assess the concept of Redemption of shares, debentures, underwriting of shares and underwriter’s liability.

Preview of last class

01 Redemption of Debenture

- Methods for Redemption of

02

03

Redemption of Debentures in Lump sum

- Redemption of Debentures by Installments by Draw of lots and by
- Purchase from Open Market

04

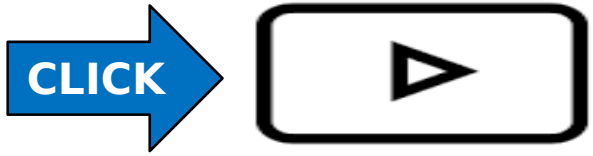
Topics Covered

- Meaning of Underwriting
- Underwriter & Types of Underwriters
- Types of Underwriting
- Underwriting Commission
- Rate of Underwriting Commission
- Determining Liability of

UNDERWRITING - LECTURE VIDEO

SOURCE

https://www.youtube.com/watch?v=Rak6JzgXAao&t=3s



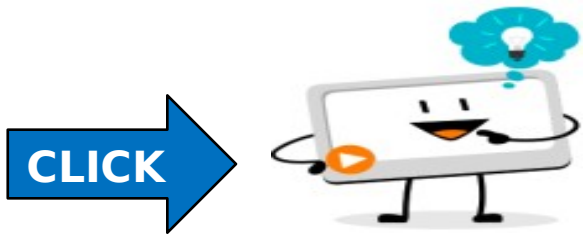
https://www.youtube.com/watch?v=jK4KNnvFnMU&t=788s

SOURCE : Animation

- by Mr. Saheb Academy, Educational Channel, IPCC.

https://www.youtube.com/watch?v=QmJObCXq_Hk

- by Mrs. Kauser Wise, Youtube Pedogogy, Chennai



Underwriting

INTRODUCTION

- In case of public limited companies the minimum subscription must be received in order to get certificate of commencement of business.

- Companies in order to ensure minimum subscription, resort to underwriting

Underwriting

MEANING

- Underwriting is an agreement, entered into, by a company with a financial agency, or individual or partnership firm, in order to ensure that if the public will not subscribe for the entire issue, of shares or debentures, made by the company, the underwriters will do the same.

The financial agency is known as the Underwriter and it agrees to buy that part of the company's issues which is not subscribed by the public, in consideration of a specified underwriting commission.

Underwriting

DEFINITION

- "Underwriting is an agreement entered into before the shares are bought by the public that in the event of the public not taking up the whole of them the underwriter will take an allotment of such part of the shares as the public has not applied for."

Underwriting

Content of Underwriting Agreement

- Period during which agreement is in force.
- Amount of Underwriting obligations.
- Amount of commission /Details of Arrangement.
- Commission may not exceed 5% on shares and 2.5% in case of debentures.
- Underwriters get their commission irrespective.

Underwriting

BENEFITS OF UNDERWRITING

- It relieves the company from the risk and uncertainty of marketing the securities.

- Underwriters have an intimate and specialized knowledge of the capital market.

- They offer valuable advice to the issuing company in the preparation of the prospectus, time of floatation etc.

Underwriting

Contd…

- It builds up investors' confidence in the issue of securities.

- The issuing company is assured of the availability of funds. Important projects are not delayed for want of funds.

- They also provide publicity service to the companies which have entered into underwriting agreements with them.

Underwriting

LIMITATIONS

- Very costly method of marketing of securities.
- Misuse of information is possible.
- Secure control on the company.

Underwriting

UNDERWRITER

- An underwriter is any party that evaluates and assumes another party's risk for a fee.
- The fee is often a commission, premium, spread, or interest. Underwriters are critical to the financial world including the mortgage industry, insurance industry, equity markets, and common types of debt security trading.
- A lead underwriter is called a book runner.

TYPES OF UNDERWRITERS

There are two types of underwriters. They are

1) Institutional underwriters

They are some institutional underwriters

- Life insurance corporation of India (LIC)
- Unit trust of India (UTI)
- Industrial development bank of India (IDBI)
- Industrial credit and investment corporation of India (ICICI)
- Commercial bank and general insurance company.

Underwriting

- The patterns of underwriting of the above institutional underwriters differ vastly in India.
- LIC and UTI have purchased industrial securities from the new issue market with a view to holding them on their own portfolio they have a performance for underwriting share in large and well established firms.
- The development banks have given special attention to the issue in Prepared by backward sates and industries in the priority list.
- The thrust of the development banks is also towards small and new issues which do not have adequate support from other institutions.

Underwriting

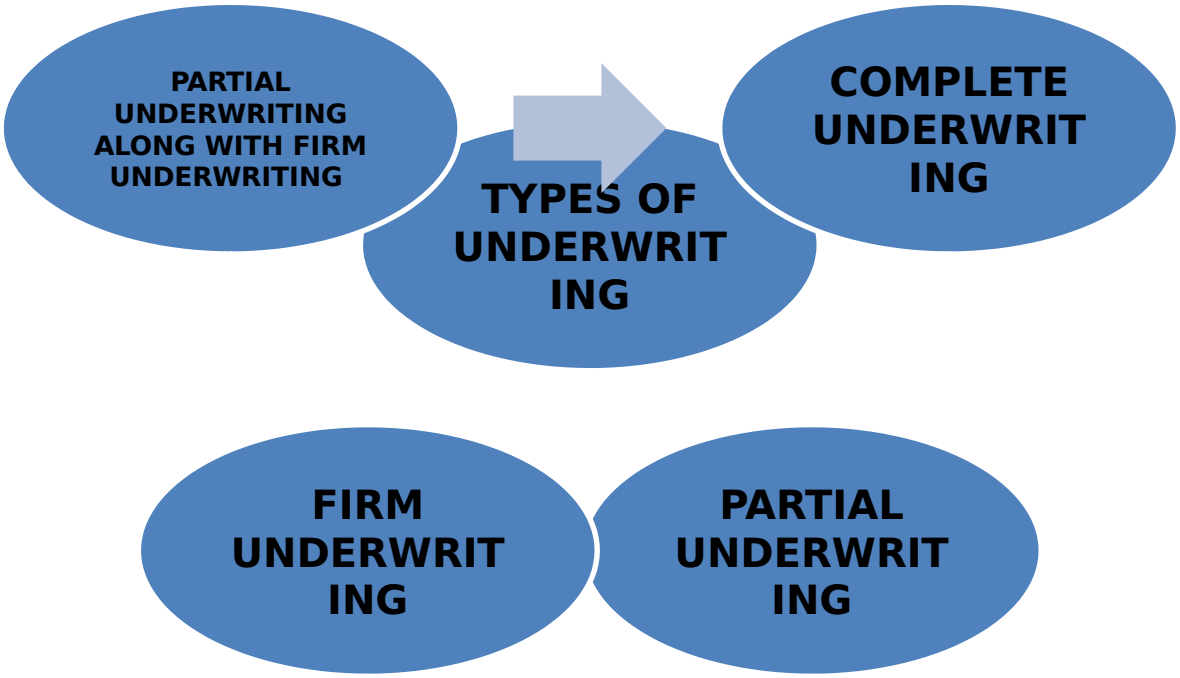
Non-Institutional underwriters

The Non institutional underwriters are brokers.

- They guarantee shares only with a view to earn commission from the company floating the issue.
- They are known to offload the shares later to makes a profit.
- The brokers work with profit motive in underwriting industrial securities.
- After the elimination of forward trading, stock exchange brokers have begun to take an underwriting business.
- The percentage of securities underwriting to the total

Underwriting Types

TYPES OF UNDERWRITING



Underwriting Types

1) Complete underwriting

- If the whole issue of shares or debentures of a company is underwritten, it is called complete underwriting.
- In such a case the whole issue is underwritten either by an individual/institution agreeing to take the entire risk or by a number of firms or institutions, each agreeing to take the risk to a limited extent.

Underwriting Types

2) Partial underwriting

- When only a part of the issue of shares or debentures of a company is underwritten, it is known as partial underwriting.

- In such a case the part of the issue is underwritten either by an individual/institution or by a number of firms or institutions each agreeing to take the risk to a limited extent

Underwriting Types

3) Firm underwriting

- Firm underwriting is an underwriting agreement where an underwriter agrees to buy a definite number of shares or debentures in addition to the shares or debentures he has already promised to subscribe under the underwriting agreement.
- In firm underwriting, the underwriters are liable to take up the agreed number of shares or debentures even if the issue is over subscribed.

Underwriting Types

4) Partial underwriting along with firm underwriting

- In this type of underwriting, unless otherwise agreed, individual underwriter does not get the benefit of firm underwriting in determination of number of shares or debentures to be taken up by him.

- Firm' underwriting signifies a definite commitment to take up a specified number of shares irrespective of the number of shares subscribed for by the public.

Underwriting Types

Contd…

- In such a case, unless it has been otherwise agreed, the underwriter's liability is determined without taking into account the number of shares taken up 'firm' by him, i.e. the underwriter is obliged to take up :

1) the number of shares he has applied for 'firm'; and
2) the number of shares he is obliged to take up on the basis of the underwriting agreement.

Underwriting Types

5) Syndicate underwriting

- When the issue is very big and it is impossible to be underwritten by a single underwriter syndicate underwriting comes to rescue. In syndicate underwriting, few underwriting firms form a syndicate and jointly undertake to underwrite the issue.
- The amount to be underwritten and the ratio is determined in advance among the firms.
- For example, For an issue of 10,000 6 underwriters may form a syndicate and underwrite in the ratio of

Underwriting Types

6) Joint underwriting

- In Joint underwriting, when the issue is too large, the issuer company itself appoint more than one underwriter to reduce the burden from a single underwriter.
- Each Underwriter underwrites for a specified amount and in a specified ratio.
- It is different from a syndicate underwriting in a way that in Syndicate underwriting the underwriting firm themselves form a syndicate and represent themselves as single underwriting firm but in Joint underwriting, the issuer company itself appoint a number of firms to underwrite the issue.

Underwriting Types

7) Sub underwriting

- If an underwriter has promised to underwrite an issue and later on it feels that it is beyond his individual capacity, then he may appoint a sub-underwriter to safeguard himself.
- For example, if an underwriter A has underwritten for an amount of 40 crores, and later on he finds it difficult to underwrite single Handedly he may appoint a sub-underwriter to underwrite 10 crores.
- In this case, the sub-underwriter is liable to underwriter only and he has no connection with the company. the relationship between underwriter and sub-underwriter is same as an agent

Underwriting

Disclosure Requirement

- Provisions of the Companies Act, 2013 regarding disclosure of underwriting agreement :
  - ✓ Disclosure in the Prospectus.
  - ✓ Disclosure in the Statutory Report.
  - ✓ Disclosure of Sums Payable.

Underwriting

Underwriting Commission

- Underwriting commission is a payment, which is given by the company, to underwriters for their services of underwriting.

- Companies can give maximum 5% commission to underwriters for selling its shares.

Underwriting

Payment of Underwriting Commission

- According to Companies Act, 2013, a company is authorized to pay such commission subject to following restrictions:
  - Articles must authorize the payment of commission.
  - The rate of commission must not exceed 5% of the issue price of shares or the amount or rate authorized by articles whichever is less and
  - In case of debentures, 2.5% of the issue price or the amount or rate authorized by articles, whichever is less.
  - In practice, SEBI has allowed the commission only at the rate of 2.5% of issue price of equity shares though Section 76 provides for maximum rate of 5%.

Underwriting

Contd…

- The commission paid or agreed to be paid must be disclosed in the prospectus and if no prospectus is issued, in the statement in lieu of prospectus.
- The number of shares or debentures which underwriters have agreed to subscribe absolutely or conditionally should be disclosed in the prospectus.
- A copy of the contract regarding the payment of commission should be delivered to the registrar.
- The commission is only payable if the shares or debentures are offered to the general public. No underwriting commission can be paid if the issue is privately placed.

Underwriting

As per SEBI guidelines:

- Underwriting is not mandatory. In case the issue is not underwritten and minimum subscription of 90% of the offer to the public is not received, the entire amount received as subscription would have to be refunded if full.

- In case the issue is underwritten and if the company does not receive 90% of issued capital from the public subscription plus accepted development from underwriters, with in 120 days from the date of opening of the issue, the company shall refund the amount of

Underwriting

Contd…

- The lead managers must satisfy themselves about the net worth of the underwriters and the outstanding commitments and disclose the same to SEBI.

- The underwriters agreement may be filed with the stock exchange.

Underwriting

Rate of Underwriting Commission

	On amounts developing on the underwriters (%)	On amounts subscribed by the public (%)
(A) EQUITY SHARES	2.5	2.5
(B) PREFERENCE SHARES/ CONVERTIBLE AND NON CONVERTIBLE DEBENTURES		
(i) For amounts upto 5 lacs	2.5	1.5
(ii) For amounts in excess of 5 lacs	2	1

Underwriting

MARKED OR UNMARKED APPLICATIONS

- Shares or debentures issued by a company are usually underwritten by two or more firms of underwriters in an agreed ratio.
- Every underwriter wants to sell the maximum number of shares and debentures in order to reduce his risk.

Marked application

- Generally the forms are stamped with the name of the underwriters in order to distinguish the forms of one underwriter from that of others and to determine the liability of the individual underwriter.

Underwriting

- Such stamped applications when received are called marked applications.

Unmarked application

- The application forms which are received by the company without any name of the underwriter are called unmarked applications.

DETERMINING THE LIABILITY OF UNDERWRITERS

COMPLETE UNDERWRITING

(I) If the whole issue of the shares or debentures is underwritten only by one underwriter:

The liability of underwriters will be determined by deducting the total application money received from the shares or debentures offered to public.

Determining the liability of underwriters

Contd…

(II) If the whole issue of the shares or debentures is underwritten by number of underwriters in an agreed ratio:

There are two ways of determining liability:

(i) The liability of each underwriter in this way will be:

Gross liability according to agreed ratio	xxx
Less: Marked applications	xxx
Balance left	xxx
Less: unmarked application (in the ratio of Gross liability)	xxx
Net liability	xxx

Determining the liability of underwriters

Contd…

(ii) The liability of each underwriter in this other way will be:

Gross liability according to agreed ratio	xxx
Less: Marked applications	xxx
Balance left	xxx
Less: unmarked applications (in the ratio of balance left, i.e., gross liability as reduced by marked applications)	xxx
Net liability	xxx

Determining the liability of underwriters

Contd…

PARTIAL UNDERWRITING

(a) If a part of the issue of shares or debentures is underwritten only by one underwriter:

In this case liability to be determined can be understood with the help of following illustration:

Illustration: A entered into an underwriting agreement with B Ltd. for 60% of the issue of Rs.50,00,000 15% debentures with a firm underwriting of Rs. 5,00,000. Marked applications were for Rs. 35,00,000 debentures. Calculate the liability of the underwriter and the commission payable to him.

Determining the liability of underwriters

Contd…

Solution:

Net liability of A being 60% of Rs.50,00,000 i.e., Rs.30,00,000

Since the issue is oversubscribed and there is a firm underwriting the liability of underwriter will be limited to the extent of firm underwriting i.e. Rs.5,00,000

Commission 2.5% of 30,00,000rs = 75,000 rs.

Determining the liability of underwriters

Contd…

(b) **If the part of the issue of shares or debentures is underwritten by a number of underwriters:**

In such a case only a part of the whole issue(say 70% or 80%) is underwritten by a number of underwriters and the balance (i.e.30% or 20%) is concerned, the company itself is the underwriter of the same. All unmarked applications are treated as marked applications so far as the company is concerned. The method of determining net liability is similar to the method II (a)

Determining the liability of underwriters

Contd…

FIRM UNDERWRITING

- Firm underwriting means when an underwriter agrees to buy a definite number of shares or debentures in addition to the shares or debentures he has to take under the underwriting agreement.

- In case of firm underwriting the underwriters get priority over the general public, if shares or debentures are oversubscribed.

Journal Entries in the Books of the Company

xxx
To Share Capital A/c
xxx
To Debentures A/c
xxx
(Balance of shares and debentures allotted to underwriters)

2. For commission due:
Underwriting Commission A/c Dr
xxx
To Underwriters
xxx

3. For payment of commission:
Underwriter A/c Dr
xxx
To Bank (cheque)
xxx
To Share Capital A/c (shares)
xxx
To Debentures A/c (debentures)
xxx

4. For the balance amount due from underwriters received:
Bank A/c Dr

Test Your Knowledge

LINK

https://docs.google.com/forms/d/e/1FAIpQLScb6SBBsjMQt2y296hch9odSkzZXM27USFdiUhB42hmWKIuBQ/viewform

CLICK

THANK YOU